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Chief Administrative Officer

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To: Mayor Michael D. Antonovich
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

From: David E. Janssen
Chief Administrative Officer

SACRAMENTO UPDATE

Legislative Analyst Releases "Overview of the 2006-07 May Revision"

Today, the Legislative Analyst's Office (LAO) released its analysis of the Governor's May Revision. The LAO believes the May Revision proposal to use increased new revenue for repayment of debt, one-time purposes or increasing year end reserves, is a sensible approach in light of the State's structural budget deficit. The LAO also recommends and urges the Legislature to adopt ongoing solutions that are similar in magnitude to those proposed by the Administration. Even though there are substantial increases in revenues through the budget year, the LAO predicts ongoing operating deficits of over $4 billion in FY 2006-07 and over $3 billion in FYs 2007-08 and 2008-09. The State is expected to have $21.6 billion in outstanding debt by the end of FY 2006-07 even with the dedication of $1.6 billion in additional revenues to pay off outstanding obligations.

Key Features of the May Revision

Economic and Revenue Projections. According to the LAO, the Administration's $7.5 billion increase in General Fund revenues is primarily related to stronger-than-expected April receipts from the personal income tax as a result of a strong economy. LAO points out that the Administration's economic forecast has not changed significantly since the January proposal and continues the assumption that economic growth will be less than the pace experienced in 2005. The outstanding pressures on the economy remain the potential softening of the real estate market and the long term outlook for energy prices. Since January, the real estate market has slowed in an orderly manner but does not show indications of a sharp decline. Energy costs have rebounded faster than anticipated and though it has not had a major impact on consumer spending, recent reports indicate a decline in consumer confidence which may be worth monitoring over the next few months.

A substantial portion of the new revenues are attributable to capital gains from large stock and real estate transactions. According to the Administration, these revenues are substantially of a one-time nature and the 40 percent increase in taxes attributable to capital gains is not likely to reoccur in the budget year. Revenues are only expected to increase by two percent between the current and budget years. Accordingly, the Administration and the LAO agree that prudence in expenditures is appropriate in the allocation of these additional revenues.

Use of New Revenues. According to the LAO, the Governor's revised budget plan proposes to allocate the $7.5 billion in additional resources in three areas. The proposals include $4.3 billion for increased program spending including K-14 schools, public safety, and flood control. K-14 schools would receive an additional $2.1 billion in FY 2005-06 and $800 million in FY 2006-07. As part of a settlement of a funding lawsuit between the State and the schools, the State would agree to another $2.9 billion in payments over a seven-year period beginning in FY 2007-08.

The second proposal is to allocate $1.6 billion to reduce new or existing budgetary debt. The Governor recommends allocating $1 billion as a prepayment of the deficit financing bonds. This outstanding bond, currently totaling $10 billion, would allow the state to retire the bond early in FY 2009-10. The LAO, however, questions whether the $1 billion prepayment of the deficit reduction bonds is the optimal use of resources considering that the State will not realize the benefit of these expenditures until FY 2009-10. The remainder will be used to make payments to special fund loans and other outstanding obligations. The LAO raises an issue of whether the payment against other obligations, such as mandates, would be a more appropriate use of funds.

Finally, the Administration proposes $1.6 billion to increase the year end reserve from $600 million to $2.2 billion. The reserve could fund the cost of future collective bargaining agreements and other obligations that have not yet been quantified.

The budget subcommittees in both houses will begin their hearings on the Governor's May Revision this week.

The LAO's report is available at http://www.lao.ca.gov.

We will continue to keep you advised.

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